

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 93-750-C - ORDER NO. 94-539 ✓

JUNE 9, 1994

IN RE: Request of Pond Branch Telephone)	ORDER DENYING
Company for Approval of Optional)	PETITION FOR
Extended Area Calling Plan.)	REHEARING AND
)	RECONSIDERATION

This matter comes before the Public Service Commission of South Carolina (the Commission) on the Petition for Rehearing and Reconsideration filed by the Consumer Advocate for the State of South Carolina (the Consumer Advocate). For the reasons stated below, the Commission has determined that the Consumer Advocate's Petition for Rehearing and Reconsideration must be denied.

In his Petition, the Consumer Advocate alleges error in the Commission's determination that 12.64% is a fair and reasonable rate of return on rate base for Pond Branch Telephone Company (Pond Branch). The Consumer Advocate sets forth four main arguments in favor of this Commission granting a rehearing or reconsideration of its original Order which approved Pond Branch's extended area calling plan and approved a rate of return on rate base.¹ First,

1. In his Petition, the Consumer Advocate does not dispute the approval of the extended area calling plan which was approved in Order No. 94-400. The Consumer Advocate's Petition addresses only the rate of return on rate base authorized by the Commission in Order No. 94-400.

the Consumer Advocate alleges that the Commission's decision regarding the appropriate rate of return was not fully documented in its findings of fact and not based exclusively on reliable, probative and substantial evidence on the whole record. Second, the Consumer Advocate alleges that the Commission acted arbitrarily, capriciously, and contrary to the evidence of the record and abused its discretion in violation of S.C. Code Ann. §1-23-380 in its decision regarding the appropriate rate of return for Pond Branch. Third, the Consumer Advocate submits that the Commission abused its discretion in violation of S.C. Code Ann. §1-23-380 by using the "increased cost of regulation" as a basis of its ruling in this case. Lastly, the Consumer Advocate alleges that the Commission violated S.C. Code Ann. §1-23-380 by an "implicit finding" in Order 94-400 which results from an error of law regarding the Commission Staff's (the Staff's) interpretation of a South Carolina Supreme Court opinion.

The Consumer Advocate alleges the Commission's decision in approving a 12.64% rate of return on rate base for Pond Branch violated S.C. Code Ann. §58-9-540 (E) (Supp. 1993) in that the Commission's decision is not fully documented in its findings of fact and not based exclusively on reliable, probative and substantial evidence on the whole record. Upon examination of Order 94-400, the Commission believes that this allegation is erroneous. Order 94-400 delineates specifically the testimony of Dr. Legler and Dr. Avera. While the Commission noted weaknesses associated with the methodology and testimony of Drs. Legler and

Avera regarding the lack of market data of a utility such as Pond Branch and the lack of a comparable sample, the Commission determined that the risk premium recommended by Dr. Avera more closely reflected the risk factor faced by Pond Branch and concluded that Dr. Avera's recommended risk premium is more appropriate for Pond Branch than that suggested by Dr. Legler.

The conclusions reached by the Commission are clearly tied to the testimony. The case of Seabrook Island Property Owners Association v. South Carolina Public Service Commission, ___ S.C. ___, 401 S.E.2d 672 (1991) is pertinent authority in this case. The Seabrook Island case held that no particular format for setting forth findings or conclusions is required nor is it necessary that findings of fact and conclusions of law be stated or enumerated under separate headings. 401 S.E.2d at 674. As stated in the Seabrook Island case, in Order No. 94-400 there is a clear connection between points listed in the testimony and conclusions subsequently reached by the Commission, i.e. a fixed correlation between the findings and conclusions. Furthermore, findings of fact and conclusions of law need only be sufficiently detailed to allow a reviewing court to determine whether fact findings are supported by the evidence and whether the law has been correctly applied. Cloyd v. Mabry, 295 S.C. 86, 367 S.E.2d 171 (Ct. App. 1988). Therefore, the Commission believes that Order No. 94-400 was in full compliance with S.C. Code Ann. §58-9-540(E) (Supp. 1993) in that the Commission made findings of fact which were supported by the evidence in this case.

In particular the Consumer Advocate alleges that the Commission rejected using the cost of equity as a means of determining the revenue requirements for Pond Branch but then proceeded to rely upon the testimony of Dr. Avera, Pond Branch's witness. The Consumer Advocate argues that it is contradictory and an abuse of discretion for the Commission to find that the cost of equity does not sufficiently increase the accuracy of a rate of return estimate and to then rely on Dr. Avera's testimony. The Commission did not, as the Consumer Advocate alleges, "reject" use of the cost of equity as a means of determining the revenue requirements for small telephone utilities. While the Commission expressed concern about the "problems associated with trying to determine a reliable and fair cost of equity estimate for a small regulated utility such as Pond Branch," the Commission properly found that there is no justification for giving costs of equity estimates the same weight that such estimates are accorded for larger utilities which have appropriate market data readily available. Order 94-400 at pp. 17-18. As stated in the Order, the Commission gave the testimony of Drs. Legler and Avera "the weight within its decision process that it warrants." Order 94-400 at p. 18. The Commission considered and weighed both Dr. Legler's and Dr. Avera's testimony regarding cost of equity and rate of return.

The Commission is well aware of the difficulties and weaknesses of estimating the cost of equity of a small utility such as Pond Branch which does not have direct market data. While

certain approaches can be readily applied to larger utilities with market data and financial information available, the Commission is cognizant that it is often difficult to accurately estimate the cost of equity for much smaller utilities which are significantly different in terms of business and financial risks. The Commission stated in Order 94-400 that "[t]his broad range (11% to 17%, or 600 basis points) is indicative of the numerous problems associated with trying to determine a reliable and fair cost of equity estimate for a small regulated utility such as Pond Branch. Such a broad range of estimates does not give the Commission a clear indication of an appropriate cost of equity value." Order 94-400 at p. 17. The resulting broad range of estimates was the Commission's basis for concluding that consideration of cost of equity did not contribute sufficiently to or increase the accuracy of the rate of return estimate.

The Consumer Advocate argues further that the Commission merely recited the testimony of Dr. Legler and Dr. Avera, then chose the testimony of Dr. Avera as the basis of its decision. To the contrary, the Commission made specific findings that "the business risk and financial risk of Pond Branch exceeds that of the sample utilized by Dr. Legler" and that "[t]he risk premium recommended by Dr. Avera ... more adequately reflects this additional risk [and] is more appropriate than the premium applied by Dr. Legler." Order No. 94-400 at p. 19. The Commission accepted, for the purposes of this case, Dr. Legler's estimates concerning the cost of equity for his sample of companies. The

Commission stated that to apply Dr. Legler's results to Pond Branch would require "the assumption that the business risks and financial risks of the large companies are similar in type and magnitude to those of the small company." Order No. 94-400 at 17. The Commission rejected this assumption and accepted Dr. Avera's risk premium to account for the differences between Pond Branch and the companies sampled by Dr. Legler. Order 94-400 at 17.

Next, the Consumer Advocate argues that the Commission's reliance on the testimony of Dr. Avera is improper because Dr. Avera used the analysis supplied by Dr. Legler as a benchmark for his conclusions. While it is true that an expert may not base his opinion solely on the opinion of another expert, Glenn v. Dunnean Mills, 242 S.C. 535, 131 S.E.2d 696 (1963), it is also true that the facts upon which an expert's testimony is based may be facts testified to by other witnesses. See Mallard v. Colonial Life & Accident Ins. Co., 326 S.E.2d 6,7 (Ga. App. 1985) ("While an expert may base his opinion on facts provided to him by others, he may not simply restate the opinion of another expert.") For purposes of his testimony in this case, Dr. Avera accepted Dr. Legler's base estimates as a reasonable benchmark for Dr. Legler's benchmark groups. Tr. Vol. 3, pp. 92, 109. Accepting those estimates as facts testified to by Dr. Legler, Dr. Avera considered additional facts relating to levels of risk and gave his opinion regarding an appropriate risk premium and a fair rate of return for Pond Branch. As Dr. Avera's testimony was based on facts testified to by Dr. Legler, not the opinion of a fair return stated by Dr. Legler, Dr.

Avera's testimony was properly before the Commission for consideration.

The Consumer Advocate argues that there is no reliable basis in the record to support the quantification of any additional risk for smaller companies such as Pond Branch. Dr. Avera cited several examples of financial literature to support the "well established" proposition that a company's size affects its relative risk. Tr. Vol. 3, p. 84. Dr. Avera also cited the Ibbotson and Associates data on "Small Company Stocks," which indicates that smaller New York Stock Exchange Companies (which are still many times larger than Pond Branch) have historically earned higher rates of return than the large companies which comprise the Standard & Poor's Corporation 500. Tr. Vol. 3, pp. 91-92. Furthermore, the Ibbotson and Associates data for publicly traded companies reflects that the cost of equity for smaller publicly-traded companies exceeds that for large companies by 5.1 percent, or over 500 basis points. Tr. Vol. 3, p. 92. Dr. Avera also stated that additional risk differences are appropriate due to Pond Branch's smaller size and due to the fact that it is not publicly traded. Id. Dr. Avera further testified that "there is considerable evidence that, because of illiquidity, the cost of equity for a closely-held firm averages approximately 50 per cent more than for its publicly-traded counterparts." Tr. Vol. 3, p. 93. Therefore, the Commission believes the record supports and quantifies the additional risk premium for smaller companies.

Since adequate market data is not available on Pond Branch, or

on a comparable risk regulated utility, it is impossible to specifically identify or demonstrate the exact level of the appropriate risk premium. The high degree of uncertainty pertaining to the cost of equity estimates is part of the concern that the Commission has in attempting to rely solely on the cost of equity estimates for such small regulated utilities. The Commission believes that Dr. Avera supported the level of his risk premium and did so more convincingly than Dr. Legler. The Commission believes that the testimony of Dr. Avera does in this case support and quantify a risk premium of 510 basis points due to Pond Branch's size, illiquidity, access to capital, vulnerability to disasters, and other factors.

While the Commission noted the weaknesses in the available methodologies for attempting to estimate the cost of equity for Pond Branch, the Commission also considered the cost of equity testimony of both witnesses to the extent that the Commission believed was warranted. The Commission did not disagree with the estimates of Dr. Legler for his sample of companies, but the Commission did not believe that Dr. Legler's sample companies reflected business and financial risk comparable of the much smaller Pond Branch. The issue in this particular case in attempting to make use of the cost of equity testimony was the determination of an appropriate risk premium to be added to the sample estimate of Dr. Legler. The Commission rejected Dr. Legler's risk premium as inadequate and accepted the recommendation of Dr. Avera as more appropriate. Adding the risk premium of Dr.

Avera to the cost of equity of Dr. Legler's sample resulted in a range for the return on rate base for Pond Branch from 12.64% to 13.24%. This range was consistent with and supported the Commission's earlier return on rate base of 13.00% which was derived without any cost of equity input in Commission Order 93-750-C dated September 20, 1993.

The Consumer Advocate next argues that the Commission erred in its decision to continue to use the return on rate base, without regard to the resulting implied return on equity, for Pond Branch and other small telephone utilities. In Order No. 93-750-C dated September 20, 1993, the Commission used its discretion and knowledge of the telecommunications industry to determine that a 13.00% overall rate of return on rate base was appropriate for Pond Branch. The Commission considers a broad array of financial and business factors in arriving at an allowed rate of return on rate base. In the present proceeding, the Commission adjusted Pond Branch's overall rate of return after considering cost of equity testimony presented by the Consumer Advocate and Pond Branch reflecting currently existing conditions. While the Commission will continue to use rate of return on rate base as the basis for determining the revenue requirements for small telephone companies like Pond Branch, there is no basis for the Consumer Advocate's assertion that this is or will be done "without regard to" cost of equity. As previously stated, the Commission will give the cost of equity testimony "the weight within its decision process that it warrants." Order No. 94-400 p. 18.

The Consumer Advocate also alleges that the Commission stated arbitrarily, capriciously, and contrary to the evidence of the record and has abused its discretion in violation of S.C. Code Ann. §1-23-380 in its decision regarding the appropriate rate of return for Pond Branch. This Commission is granted the authority to fix the rate of return which a public utility is given the opportunity to earn, and this Commission is the designated expert to regulate rate and services of public utilities in South Carolina. For the reasons stated above, the Commission believes that its decision was based on substantial evidence in the record and that its decision was not a result of arbitrariness, capriciousness, contrary to the evidence or an abuse of discretion. Based on the reasoning above, this ground which the Consumer Advocate asserts for reconsideration is denied.

The Consumer Advocate also argues that the Commission abused its discretion by using the "increased cost of regulation" as a basis of its ruling in this case. While the Commission expressed concern about the costs associated with extensive presentation of testimony on cost of equity, the Commission did not use these additional costs as a basis for continuing to rely on the rate of return on rate base approach for Pond Branch. The Commission determined that the testimony provided by the cost of equity witnesses in this case did not provide sufficient improvement in the estimation of a fair and reasonable rate of return on rate base to justify additional costs to the ratepayer. The Commission feels that the cost of regulation should be an important consideration

for all parties involved in the regulatory process.

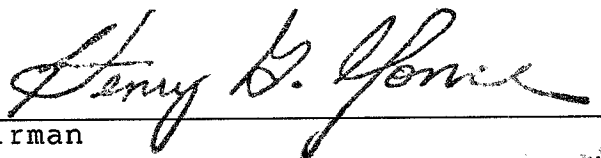
The Consumer Advocate also asserts error in what he calls an "implicit finding" which suffers from an error of law in Staff's interpretation of Hamm v. South Carolina Public Service Commission and South Carolina Electric and Gas Company, ___ S.C. ___, 422 S.E.2d 110 (1992). The Consumer Advocate alleges that during the Commission's deliberations of this matter that Staff erroneously advised the Commission as to the holding of the Hamm case. The Commission believes that Staff's interpretation of the Hamm case was correct and that no error of law resulted. In any event, there is no evidence in the record to support the Consumer Advocate's assertion. Furthermore, to the extent there has been any question concerning the basis for the Commission's determination in this case, such question is now resolved by virtue of the fact that the Commission has now had the opportunity to reconsider its determination in light of the Consumer Advocate's assertions.

The Commission therefore holds that the Petition for Rehearing and Reconsideration must be rejected and therefore denied, pursuant to the reasoning stated above. We affirm our earlier Order. The Commission's determination that 12.64% is a fair and reasonable rate of return on rate base for Pond Branch is fully documented in Order 94-400 and is supported by reliable, probative and substantial evidence on the whole record.

IT IS THEREFORE ORDERED THAT:

1. The Petition for Rehearing and Reconsideration filed by the Consumer Advocate is hereby denied.

2. This Order shall remain in full force and effect until further Order of the Commission.


Chairman

ATTEST:


Executive Director

(SEAL)